

STATE OF NEW YORK
DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
SANDRICH, INC.	:	
T/A BRUCE'S YOGURT	:	
for Revision of a Determination or for Refund	:	
of Sales and Use Taxes under Articles 28 and 29	:	
of the Tax Law for the Period September 1, 1984	:	
through August 31, 1985.	:	DETERMINATION
	:	DTA NOS. 808753
	:	AND 808748
In the Matter of the Petition	:	
of	:	
RICHARD A. FREEDMAN, OFFICER OF	:	
SANDRICH, INC. T/A BRUCE'S YOGURT	:	
for Revision of a Determination or for Refund	:	
of Sales and Use Taxes under Articles 28 and 29	:	
of the Tax Law for the Period September 1, 1984	:	
through August 31, 1985.	:	

Petitioners, Sandrich, Inc. t/a Bruce's Yogurt and Richard A. Freedman, as officer, P.O. Box 1161, Melville, New York 11747-0420, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 1984 through August 31, 1985.

A consolidated hearing was held before Robert F. Mulligan, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on February 25, 1991 at 1:15 P.M., with all briefs filed by September 16, 1991. Petitioners appeared by Richard A. Freedman. The Division of Taxation appeared by William F. Collins, Esq. (Donald C. DeWitt, Esq., of counsel).

ISSUE

Whether a sales tax audit of Sandrich, Inc. t/a Bruce's Yogurt properly determined taxes due, where the audit was based on gross sales projected from a rental factor.

FINDINGS OF FACT

Petitioner Sandrich, Inc. ("the corporation") was organized on May 21, 1984. Its president was petitioner Richard A. Freedman.

On or about May 21, 1984, the corporation acquired an operating yogurt bar known as Bruce's Yogurt. The business was in a large market known as The Pea Patch, located at 8285 Jericho Turnpike, Woodbury, New York.

The operators of The Pea Patch, in addition to selling high-quality produce, subleased space to various entrepreneurs selling specialties such as delicatessen products, baked goods, coffee (beans and by the cup), seafood, yogurt and other items.

The corporation subleased space toward the rear of The Pea Patch. Its counter was about 20 feet in length. Included with the sublease was a large amount of warehouse space which the business did not need. The monthly rental was \$3,276.00 and included utilities, garbage collection, advertising and promotion, cleaning, repairs and maintenance.

The business sold nothing but yogurt, toppings, tofu and cookies. In addition to individual sales for on-premises consumption, yogurt was sold in pints and quarts for take-out and cookies were sold by the box.

Although business was good at first, it deteriorated as The Pea Patch developed business problems. The operators of The Pea Patch fell into rental arrears, and in June 1985 the owner of the building commenced eviction proceedings against The Pea Patch and all subtenants, including the corporation.

About the time eviction proceedings were commenced, petitioner Richard A. Freedman learned that a Swenson's Ice Cream Store located across the shopping center from The Pea Patch was for sale.

Mr. Freedman acquired the ice cream store and went to Arizona for two weeks' training

with Swenson's. On or about August 14, 1985, he closed Bruce's Yogurt and moved the corporation's yogurt machines to the Swenson's store. Shortly thereafter, The Pea Patch was closed and all of its subtenants were evicted.

The Audit

A sales tax audit of the corporation was commenced in September 1987. The audit findings may be summarized as follows:

(a) Records available for audit were: sales tax returns, Federal corporation income tax return (Form 1120) and State corporation franchise tax return (Form CT-3) for the period May 1984 through December 31, 1984, cash receipts summary for January 1, 1985 through August 15, 1985, cash receipts for September 1984 through December 1984, check disbursements summary for January 1, 1985 through August 15, 1985, check disbursements journal for January 1, 1985 through August 15, 1985, computerized general ledger (incomplete) running from May 1984 through December 31, 1984 (no such records for 1985), monthly bank statements for August 15, 1984 to August 15, 1985, balance sheet for the period ending December 31, 1984 and payroll for January 2 through January 9, 1985.

(b) Records requested but not made available included: sales invoices, purchase invoices, cash register tapes, daily log or daybook.

(c) Sales tax returns for the period September 1, 1984 through August 31, 1985 show the following:

<u>Period</u>	<u>Gross Sales</u>	<u>Taxable Sales</u>	<u>Tax Due</u>	<u>Tax Paid</u>
9/1/84-11/30/84	\$ 56,984.00	\$31,513.00	\$2,599.00	\$2,599.00
12/1/84-2/28/85	40,567.00	19,831.00	1,636.00	1,636.00
3/1/85-5/31/85	50,770.00	24,145.00	1,991.00	1,991.00
6/1/85-8/31/85	-0-	-0-	-0-	--
Totals	\$148,321.00	\$75,489.00	\$6,226.00	\$6,226.00

The audit worksheets indicate that tax of \$5,262.77 was assessed for the period June 1,

1985 through August 31, 1985 under assessment number D8601067986.¹

(d) The auditor concluded that the corporation's books and records available for audit were inadequate and that the reported taxable percentage of slightly over 50% had not been documented. Accordingly, she decided to estimate taxes using rent as an index. Rent, calculated for this purpose at \$3,000.00 per month, was equated to 7.6% of gross sales, based on the National Restaurant Association's Restaurant Industry Operations Report for 1987, showing the ratio of income and expenses to total sales. More specifically, the percentage was derived from the rent factor used in the category of "Limited-Menu - No Tableservice" restaurants with sales volume under \$400,000.00. All factors for said category were as follows:²

	<u>Lower Quartile</u>	<u>Median</u>	<u>Upper Quartile</u>
Total Sales	100.0%	100.0%	100.0%
Total Cost of Sales	32.0	34.7	39.8
Gross Profit	60.3	65.3	68.0
Other Income	0.1	0.4	1.6
Total Income	60.5	65.5	68.7

¹Exhibit "E", worksheets, page E-5. The actual sales tax returns are not in the record.

²National Restaurant Association, Restaurant Industry Operations Report, 1987, prepared in cooperation with Laventhol & Horwath, CPA's, Exhibit C-15 (Exhibit "F").

Controllable Expenses			
Payroll	18.2	21.2	28.6
Employee Benefits	0.9	2.5	3.3
Direct Operating Expenses	1.9	4.1	6.4
Music and Entertainment	**	**	**
Advertising and Promotion	0.7	2.5	4.8
Utilities	2.8	4.0	5.3
Administrative and General	0.5	1.4	8.7
Repairs and Maintenance	0.8	1.6	2.4
Total Controllable Expenses	32.5	39.8	50.2
Income Before Occupation Costs	15.9	23.3	30.2
Occupation Costs			
Rent	4.2	6.2	7.6
Property Taxes	0.5	0.9	1.2
Other Taxes	0.2	0.4	2.4
Property Insurance	0.5	1.1	1.8
Total Occupation Costs	3.9	7.7	10.0
Income Before Interest and Depreciation	10.3	15.9	23.2
Interest	1.2	2.4	3.3
Depreciation	1.6	3.8	5.4
Restaurant Profit	6.1%	10.6%	18.8%

** Insufficient data.

It is noted that the 7.6% figure for rent is from the upper quartile of the range and is the percentage most favorable to the corporation.

(e) This resulted in the computation of gross annual sales of \$473,684.00, or \$118,421.00 per quarter.

(f) Expense purchases were deemed negligible and were not tested.

(g) Tax due based on audited taxable sales was \$39,078.92. After crediting the corporation with sales tax paid of \$6,226.00 and for the warranted assessment of \$5,262.00 for the period June 1, 1985 through August 31, 1985, additional tax due was determined to be \$27,590.92.

On September 23, 1987, petitioner Richard A. Freedman, as president of the corporation, executed a consent extending the period of limitation for assessment of sales and use taxes for the period September 1, 1984 through August 31, 1985 to December 20, 1988.

On December 8, 1988, notices of determination and demands for payment of sales and use taxes due post-dated December 20, 1988 were issued to the corporation, and to petitioner Richard A. Freedman and Sondra S. Freedman, as officers, in the following amounts:

<u>Period</u>	<u>Tax Due</u>	<u>Penalty</u>	<u>Interest</u>	<u>Total</u>
9/1/84-8/31/85	\$27,590.92	\$7,123.11	\$15,253.63	\$49,967.66
6/1/85-8/31/85 (omnibus penalty)	-0-	450.77	-0-	450.77

The Bureau of Conciliation and Mediation Services Conference

Pursuant to a Bureau of Conciliation and Mediation Services conference, the assessments against the corporation and Richard A. Freedman were reduced by allowances for ancillary services such as cleaning, heating, lighting, advertising, maintenance and garbage disposal, which were included in rent. Rental used in the factor was reduced from \$36,000.00 to \$22,800.00 per year, resulting in the additional taxable sales being reduced to \$300,000.00 and tax due to \$13,262.00. Omnibus penalty was reduced to \$92.55. The conferee also cancelled the assessment issued against Sondra S. Freedman, on the basis that she was not a person required to collect tax on behalf of the corporation.³

Additional Facts

(a) The corporation's Federal income tax return for the period May 21, 1984 through December 31, 1984, which was dated March 2, 1985, reported gross receipts or sales of \$145,609.00.⁴

(b) The corporation's Federal income tax return for the year 1985, which shows the date July 24, 1989 in the space for the date of the preparer's signature, reported gross receipts or sales of \$109,579.00.⁵ This return was not prepared by the corporation's original accountant, but by a second accountant who was hired to help reconstruct the corporation's records.

The cash disbursements book showed the last payroll check was dated August 14, 1985

³Transcript, page 37.

⁴Exhibit "8" to petitioner Richard A. Freedman's affidavit of April 12, 1991.

⁵Exhibit "9" to petitioner Richard A. Freedman's affidavit of April 12, 1991.

in the amount of \$71.81.⁶ Review of the cash disbursements shows that typically five or six payroll checks were drawn each week. It is noted that five checks were dated August 7, 1985. These were the last payroll checks issued prior to the one check dated August 14, 1985.⁷ No payroll checks were issued to petitioner Richard A. Freedman or Sondra S. Freedman during the period at issue.

The corporation's former accountant had generated a computerized set of records for the corporation for the year ended December 31, 1984 including balance sheet, general ledger, cash disbursements, income statement, etc.⁸ These records were reviewed by the auditor, but were essentially disregarded for lack of substantiation. (It is noted that the gross revenues shown in the income statement reconciled with sales as per Federal income tax returns for 1984.)

Petitioner Richard A. Freedman offered several explanations for the lack of records available for audit:

(a) That the corporation's former accountant moved out of state suddenly in the summer of 1985 to avoid creditors and failed to return many of the corporation's records.

(b) That some records were lost when The Pea Patch and its subtenants, including the corporation, were evicted.

(c) That other records were in petitioner's car when it was destroyed by fire on January 1, 1988.

Petitioner Richard A. Freedman claimed that "several income tax refunds" payable to his wife and him were taken by the State for sales tax allegedly due, even though this proceeding had been commenced. He claimed that the Division of Taxation had offered no explanation for

⁶Transcript, page 51.

⁷Exhibit "5" to petitioner Richard A. Freedman's affidavit of April 12, 1991.

⁸Petitioners' Exhibit "1".

this taking.

CONCLUSIONS OF LAW

A. During the period at issue, Tax Law § 1138(a) (former[1]) provided, in pertinent part, as follows:

"If a return required by this article is not filed, or if a return when filed is incorrect or insufficient, the amount of tax due shall be determined by the tax commission from such information as may be available. If necessary, the tax may be estimated on the basis of external indices, such as stock on hand, purchases, rental paid, number of rooms, location, scale of rents or charges, comparable rents or charges, type of accommodations and service, number of employees or other factors."

B. If a vendor is unable to produce the records required to be kept under Tax Law § 1135, the Division of Taxation is authorized by the above-mentioned section 1138(a)(1) to select a method of audit reasonably calculated to reflect the taxes due. It is then incumbent upon the vendor to show by clear and convincing evidence that the method of audit or amount of tax assessed was erroneous (Matter of Surface Line Operators Fraternal Organization, Inc. v. Tully, 85 AD2d 858, 446 NYS2d 451; Matter of Carmine Restaurant, Inc. v. State Tax Commission, 99 AD2d 581, 471 NYS2d 402).

C. The records offered for audit here were clearly inadequate and insufficient. Even if the records had been lost or destroyed through no fault of petitioners, the auditor was authorized to reconstruct the corporation's sales by use of external indices. The only question is whether petitioners have sustained their burden of proof to show that the method of audit or amount of tax assessed was erroneous.

D. The method used here, based on rent as an external index, is specifically authorized by statute and the use of the National Restaurant Association report was proper. The report does not have a section for yogurt bars and the category "Limited Menu - No Tableservice" appears to be the category most comparable to the corporation's type of business. Mr. Freedman's request⁹ that the Division be precluded from using the report on the grounds that he had been denied copies of certain parts thereof is denied. It is noted that petitioners have

⁹Affidavit of Richard A. Freedman, April 12, 1991, page 9.

offered no other industry report or, in fact, any statistics which would be a closer match.

Nevertheless, there are several adjustments which should be made:

(1) While the Bureau of Conciliation and Mediation Services conferee was correct in making allowances for utilities, advertising and promotion, etc., the adjustments should have been made in the terms of the percentages used for such categories in the National Restaurant Association's report, rather than by arbitrarily estimating dollar amounts. Accordingly, there should be added to the 7.6% for rent the following: utilities 5.3%; property taxes 1.2%;¹⁰ advertising and promotion listed at 4.8%, but to be adjusted to 4.3% by deducting advertising paid by the corporation;¹¹ and repairs and maintenance listed at 2.4%, but to be adjusted to 2.145% by deducting repairs and maintenance, cleaning and garbage removal paid by the corporation.¹²

The new rental factor, taking into consideration utilities, advertising and promotion, repairs and maintenance and property taxes, is as follows:

Rent	7.6%
Utilities	5.3%
Advertising/Promotion	4.3%
Repairs/Maintenance	2.145%
Property Taxes	<u>1.2%</u>
Total	
20.545%	

The correct factor to be applied is thus 20.545%, but same is to be applied against the

¹⁰These appear to be property taxes associated with occupation costs (rather than taxes on personal property) and must be taken into account here.

¹¹Adjustment based on \$1,533.00 in advertising expense and \$23,178.97 in rent shown in the corporation's income and expense statement for the year ending December 31, 1984 (petitioner's Exhibit "1").

¹²Adjustment based on \$626.72 in repairs and maintenance, \$107.83 in garbage removal and \$45.85 in cleaning, for a total of \$780.40, and \$23,178.97 in rent, all of which is shown on the corporation's income and expense statement for the year ending December 31, 1984 (petitioner's Exhibit "1").

actual rent of \$3,276.00 per month. This results in gross sales of \$191,345.82 for the period September 1, 1984 through August 31, 1985.

(2) It is also clear from the payroll records that the business was closed by August 14, 1985 at the latest. Therefore, sales projected for the last quarter should be reduced by \$8,774.51 to reflect the lack of business in the last 17 days of August 1985.

(3) While the business had some nontaxable sales of quarts and pints of yogurt and boxes of cookies, petitioners have not sustained their burden of proof under Tax Law § 1132(c) to show the amount of such sales. Essentially, the only evidence offered by petitioners on this point was the vague testimony of petitioner Richard A. Freedman. Mr. Freedman testified that nontaxable sales were "between 50 and 60 percent".¹³ This testimony, while consistent with the taxable percentage of sales reported on the sales tax returns, is insufficient evidence, particularly since petitioners offered nothing to show that pint or quart containers or cookie boxes were purchased by the corporation (not to mention the quantities of same) although the suppliers' identities and payment amounts are in the cash disbursements journal.

E. With respect to the seizure of income tax refunds from Richard A. Freedman and Sondra S. Freedman due to sales tax obligations (Finding of Fact "17"), it is noted that there is an outstanding warranted assessment (D8601067986) in the amount of \$5,262.77 (see Finding of Fact "9[c]"). This assessment is not a part of the assessments at issue here. It is suggested that Mr. Freedman examine whatever notices he and his wife received in conjunction with said seizure and determine if the refunds were applied to said assessment.

F. The petitions of Sandrich, Inc. t/a Bruce's Yogurt and Richard A. Freedman, as officer, are granted to the extent indicated in Conclusion of Law "D" and the notices of determination and demands for payment of sales and use taxes due issued December 8, 1988 are to be reduced accordingly.

¹³Transcript, page 106.

Except as so granted, the petitions are denied and the notices of determination are otherwise sustained.

DATED: Troy, New York
July 2, 1992

/s/ Robert F. Mulligan
ADMINISTRATIVE LAW JUDGE